Commodity Spotlight


USDA Photo: Ken Hammond

Is There a Tobacco Quota Buyout in the Future?

During the current session of Congress, several tobacco buyout bills have been submitted that would modify the tobacco program and provide for purchasing quota from growers or other quota holders. Quota represents the pounds or acreage of tobacco growers are allowed to market during a season. Quota can be owned by a non-farmer and rented to an active producer, or owned by a producer outright.

The bills come at a critical time for U.S. growers. During the last two marketing seasons, contracting has quickly become the dominant means of marketing tobacco, placing unprecedented strains on the tobacco program. The income-enhancing price support program functions in the context of an auction where USDA assigns grades that are linked to differing levels of price support. However, contract sales bypass the auction warehouse and are not eligible for price supports.

Additionally, because of declining demand for tobacco products and U.S. tobacco overseas, and greater use of imported tobacco, quotas (which are based on demand) have declined markedly during the past five seasons. With less quota available, quota rental rates and sales prices rise. Growers trying to maintain economic scales of operation face increasing production costs.

For these reasons, grower interest in a buyout is at an all-time high, and quota owners see an opportunity to exit with a generous payment. Some growers seem ready to give up the security of the price support safety net for greater freedom in making production decisions and marketing directly to leaf dealers and manufacturers. Growers who lease quota anticipate a buyout payment and elimination of quota rent payments in the future.

Most tobacco has been grown under a quota since the 1930s. The quota, combined with a price support program, is intended to reduce fluctuations in tobacco supply and price, stabilizing grower income.

A buyout has generally involved a voluntary or mandatory purchase of the quota for a given price over a period of time. Tobacco quota buyouts have been discussed for many years, but no agreement has been reached on the structure of a buyout and how to pay for it. However, during the past few growing seasons, changes in the way tobacco is marketed have reinvigorated the buyout discussion and new proposals have been put forward.

The first significant proposal for a quota buyout came from Senators John McCain (R-AZ) and Harold Ford (D-TN) in the LEAF act of 1997, which would have paid quota holders and growers for their quota, modified the USDA tobacco program, and had a significant economic development component.

Other proposals surfaced before the Master Settlement Agreement (MSA) was signed in November 1998 (*AO* January-February 2002). The Tobacco Transition Act sponsored by Senator Richard Lugar (R-IN) would have compensated quota owners and tenants and ended the quota and price support programs. It also included community development grants.

Other proposals included buyouts for quota owners and transition payments for growers, and would either terminate or privatize the tobacco program. Some proposals had a community development component. Participation in the buyouts was not mandatory in all proposals. The MSA reduced the pace of buyout proposals, as it addressed many of the objectives of the earlier proposals (restrictions on advertising, sales, and where people can smoke).

In 2000, the President’s Commission on Tobacco Growers and Health released its report, again proposing a quota buyout, modification of the tobacco program, economic development programs for tobacco growing areas, and greater regulation of tobacco products.

The two proposals discussed in detail below would enable tobacco growers to continue production, and both would modify the tobacco program and provide for quota buyouts. The McIntyre-Davis proposal would foster economic development in tobacco producing areas. The Goode-Boucher-Jones proposal would create a new mechanism for ensuring production/marketing rights.

Two other buyout proposals have recently been submitted in Congress. Rep. Ernie Fletcher's (R-KY) bill, known as the "Tobacco Equity Elimination Act of 2002," and Senator Max Cleland's (D-GA) bill, the "Aid to Tobacco Dependent Communities Act of 2002," both contain quota buyout provisions and would modify the tobacco program in ways similar to the Goode-Boucher-Jones proposal. These bills would each provide $5 million annually for 10 years to fund a Center for Tobacco-Dependent Communities, which would help producers and communities diversify their economic base.

McIntyre-Davis Proposal

A bill submitted to Congress by Representatives Mike McIntyre (D-NC) and Tom Davis (R-VA), known as the "Tobacco Livelihood and Economic Assistance for Our Farmers Act of 2002" (H.R. 3940), has these main features:

Termination of quota, price support, and no-net-cost programs. The current tobacco program would end.

Tobacco production limited to current production regions. Beginning in 2003, production of tobacco subject to quotas in 2002 would be limited to counties where that type of tobacco was previously grown.

Payments to quota holders. Quota holders (owners) would receive $8 per pound for their quota, paid in five equal annual installments, beginning in 2003. The volume upon which the payment is to be made is the basic quota for the 1998 marketing year. In the case of tobacco under allotments, the volume is based on the 1998 allotment multiplied by the average yield for that county.

Payments to active producers. Active producers would receive $4 per pound of tobacco produced in 2001, paid in five equal annual installments, beginning in 2003.

Establishment of a Tobacco Quality Board. The Tobacco Quality Board would consist of five grower representatives, five manufacturer representatives, and one USDA representative. Members are appointed by the Secretary of Agriculture. The Board's duties would be:

- determining and describing characteristics of U.S.-produced and imported tobaccos;
- collecting and evaluating concerns and problems with U.S. tobacco expressed by buyers and manufacturers;
- monitoring the physical and chemical integrity of U.S.-produced and imported tobacco, and
- reporting to the Secretary conditions that inhibit improvements in U.S. tobacco quality, and recommending regulatory solutions to tobacco quality issues.

Product user fees paid by manufacturers to fund Food and Drug Administration (FDA) regulation of tobacco products and quota buyout. A base fee, adjusted annually by change in sales, would be assessed on manufacturers and importers of tobacco products. Initially, the fee would total $2.3 billion annually for all tobacco products. For cigarettes, the fee equals about 10 cents per pack. Within product types, individual manufacturers or importers would be assessed pro rata based on market share. Total cost of the buyout is about $16 billion. Fifteen percent of the fee would go to FDA to fund regulation of tobacco products, and 85 percent of the fee would go to USDA to fund buyout payments or programs related to tobacco products.

FDA regulation of tobacco products.

- Manufacturers would be required to disclose on each package of tobacco product the percentage of domestic and foreign tobacco contained in the product.
- FDA provisions would not apply to tobacco leaf not in possession of a manufacturer, nor would they apply to tobacco growers, warehouses, or tobacco cooperatives.
- FDA would have no authority whatsoever to enter onto a farm without written consent of the producer/owner.

Unlike some proposals from 1998 and the Tobacco Commission recommendations, the McIntyre-Davis proposal contains no provisions for economic development in tobacco-growing regions.

Goode-Boucher-Jones Proposal

In May 2002, three legislators—Virgil Goode (I-VA), Richard Boucher (D-VA), and Walter Jones (R-NC)—introduced a bill in the House titled "Tobacco Market Transaction Act of 2002" (H.R. 4753). The purposes of the bill are to:

- terminate the tobacco program,
- replace it with a federally chartered corporation to ensure the stability of the price and supply of U.S. tobacco,
- compensate quota holders for their loss of quota, and
- provide transition assistance for current producers of tobacco.

The bill also seeks to improve the competitiveness of U.S.-grown tobacco in the world market with buyout provisions similar to those in the MacIntyre-Davis bill but with no proposed funding source and no FDA regulation. The bill would replace the current quota program with a licensing program to control tobacco production and would create a Tobacco Community Revitalization Trust Fund to compensate quota owners and growers in a way similar to the McIntyre-Davis bill.

The main features of this bill are:

Termination of the current tobacco program. Tobacco held by producer cooperatives is to be disposed of in an orderly fashion. Producer cooperatives would repay price support loans within 1 year. Grower obligations under the current program end.

Price support continued. The Corporation, in consultation with the cooperative associations and the Secretary of Agriculture, would enter into agreements with the tobacco loan associations to:

- establish a base price for tobacco based on the cost of producing that type of tobacco;
- arrange for financing and the administration of a base price for tobacco; and

The Federal Tobacco Program

The USDA tobacco program consists of marketing quotas and price supports. The program is intended to stabilize and raise prices. Excluding the 1939 crops, marketing quotas have been approved and were in effect since 1938 for each crop of flue-cured, burley, and dark tobacco. Cigar binder and Ohio filler crops first came under quotas in 1951. Price supports have never applied to Pennsylvania filler and last applied to the Maryland crop in 1965 and the Connecticut-Massachusetts binder crop in 1983.

Marketing quotas determine the quantity of tobacco that may be marketed by growers. For flue-cured and burley, which account for over 90 percent of U.S. production, quotas are determined by a three-part formula. The quota formula is the sum, in pounds of tobacco, of:

- The amount manufacturers intend to use in the following crop year, plus
- 3-year average exports, plus
- reserve stock adjustment.

The Secretary of Agriculture has the authority to raise or lower the sum by 3 percent. The result is the basic quota. The national basic quota is divided proportionally between the growers of that type of tobacco according to the amount of quota owned by each. Each grower's share is then adjusted by the accumulated over- and under-marketings from previous seasons. This is the effective quota, or the amount growers may actually market without penalty.(Growers can carry forward a maximum of 3 percent over or under their quota each year.)

Other rules of the quota program limit lease and transfer of quota and restrict sale of quota to within counties in most areas. If a producer's quota was not planted for at least 2 out of the 3 previous years, it reverts to USDA for redistribution.

The **price support program** operates in conjunction with quotas. Price supports (also known as loan rates) for flue-cured and burley are based on the previous year's price support adjusted by the change in the cost of production, and the change in the previous 5-year-average price, omitting the high and low years. Each different grade of tobacco has its own price support level or loan rate. Grade loan rates vary depending on the desirability of a given grade of tobacco—higher quality tobacco has higher grade loan rates. The weighted average of all grade loan rates for a type of tobacco is the loan rate for that type of tobacco.

Prior to being auctioned, each pile of supported tobacco is assigned a grade by a USDA inspector. If the auction bids for that pile are below the grade loan rate, the grower may turn the tobacco over to the cooperative and receive payment equal to the grade loan rate for his lot of tobacco. The cooperative then processes, packs, and stores the tobacco until a buyer can be found.

To finance its operation, the cooperative borrows money from the Commodity Credit Corporation (CCC). The cooperative must repay the CCC the expenses associated with its support operation. If the costs of processing, storing, and selling the tobacco is greater than the selling price, the deficit is paid through an assessment levied on each pound of tobacco sold and paid by buyers and sellers at the time the tobacco is sold. The no-net-cost program ensures that the costs of the tobacco program are not borne by U.S. taxpayers, but by the tobacco growers themselves.

However, CCC loans to the flue-cured, burley, and cigar binder cooperatives resulting from a poor-quality crop in 1999 were forgiven as a result of special legislation in 2000 and 2001. The CCC took title to the tobacco and forgave the loans to the cooperatives at a cost of $660 million to the U.S. Treasury.

- receive, process, store, and sell any domestically produced tobacco received as collateral for a base price loan.

Quota buyout and grower transition payments.

- Compensate quota holders for the loss of tobacco quota asset value ($8 per pound, based on 2002 quota or the average of the 1997-99 marketing years' quota).
- Provide transition assistance for active tobacco producers ($4 per pound, based on 2002 quota or the average of the 1997-99 marketing years' quota).

Establishment of the federally chartered Tobacco Production Control Corporation. The Corporation will be governed by a board consisting of 25 members, including:

- the Secretary of Agriculture, who shall appoint:
  - two members from each state that produces more than 250 million pounds of tobacco;
  - one member from each state that produces more than 50 million pounds, but less than 250 million pounds, of tobacco; and
  - one member, to be appointed on a rotating basis, from a state that produces less than 50 million pounds of tobacco.
  - four members representing domestic tobacco product manufacturers, except that:
    - no manufacturer may have more than one member on the Board;

   - at least one of the members must be from a domestic smokeless tobacco manufacturer; and
   - one member must be from a domestic cigarette manufacturer that comprises less than 5 percent of domestic cigarette sales, or a cigar manufacturer, or a pipe tobacco manufacturer on a rotating basis.
 - one member representing domestic export leaf dealers.
 - one member to be responsible for operating the quality assurance system of the Corporation.
- three members appointed by flue-cured tobacco associations and two members appointed by burley tobacco associations.
- one member appointed by tobacco associations other than flue-cured and burley, on a rotating basis.
- three members appointed by the Secretary of Health and Human Services, representing public health interests.

Licenses to market tobacco issued to current tobacco producers. The Corporation would give licenses to growers who produced tobacco in the 2001 or 2002 crop year, which would permit them to market a similar quantity of tobacco in the 2003 crop year and thereafter.

Inspection and grading of domestic and imported tobacco. A system would be set up to grade and inspect tobacco.

Increase competitiveness of domestically produced tobacco. Costs associated with buying or leasing quota would be eliminated.

Transition payments would be considered for other persons adversely and directly affected by termination of the Federal tobacco program. These include graders, inspectors, warehousemen, auctioneers, equipment dealers, and other persons.

After 3 years, the program would be subject to a referendum at the request of one-third of the growers of any specific kind of tobacco. If half of the growers vote to end the license program, another referendum would be held a year later. If half of the growers again vote against the program, the program is terminated. The Corporation may hold referenda at any time to determine the continued existence of the program, or other matters regarding the program.

Implications for Producers

Both of these buyout proposals contain provisions that enable tobacco producers to continue to grow tobacco. Growers benefit from transition payments and continued restrictions on the right to market tobacco. The McIntyre-Davis bill pays growers $4 per pound of quota and restricts production to counties that previously produced tobacco. The Goode-Boucher-Jones bill also pays growers $4 per pound of quota and restricts production through licenses issued to current producers. The Goode-Boucher-Jones bill also provides for price support through the Tobacco Production Control Corporation in conjunction with existing cooperatives.

Unlike the buyout in Maryland, the purpose of these proposals is not to restrict tobacco production. In Maryland, buyout participants had to promise never to grow tobacco again.

One purpose of a quota buyout is to eliminate the equity inherent in the "right" to grow tobacco (i.e., own quota) so that the producer actually growing the tobacco is the only possible beneficiary of the right to grow it. This eliminates quota as a factor in the cost of producing tobacco, lowering overall costs and increasing competitiveness. Currently, a producer who also owns quota does not pay himself rent, but there is an opportunity cost to holding quota because it has intrinsic value. A grower who rents the quota he grows must pay the owner, boosting his cost. When the cost of producing tobacco is inflated by the value of the right to grow it, it is more difficult for U.S. producers to be competitive against foreign tobaccos. The proposals that have been submitted would eliminate the equity issues associated with quota. AO

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